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IN THE

Supreme Court of the United States

October Term, 1974

Docket No. 74-742

FOREMOST-McKESSON, INC.,

Petitioner,

v.

PROVIDENT SECURITIES COMPANY,

Respondent.

REPLY BRIEF FOR PETITIONER

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This brief is submitted in reply to Respondent's Brief in Opposition ("Res. Br."). Respondent argues that the Ninth Circuit's decision should stand, but it concedes that the decision has created a direct conflict with explicit holdings of the Second and Eighth Circuits on a fundamental point of interpretation of Section 16(b). Economic planning requires that a holder of more than 10% of a class of equity securities knows whether his initial purchase of such securities will bring a subsequent short-swing sale within Section 16(b) or not. Although the legislative history and the stated purpose of the statute place the "responsibility

for meticulous observance of the provision upon the shoulders of the insider," *Bershad* v. *McDonough,* 428 F.2d 693, 696 (7th Cir. 1970), *cert. denied,* 400 U.S. 992 (1971), until the present conflict is resolved the burden on the 10% holder of "meticulous observance" becomes unreasonably heavy.

We will forego detailed response to Respondent's arguments until such time as briefs on the merits are required, and confine ourselves at this time to but a few observations on certain of the matters raised in the Brief in Opposition.

I

Respondent seems to suggest that certiorari should be denied because "only" two other Courts of Appeal have ruled upon the question in issue contrary to the ruling of the Ninth Circuit. (Res. Br. p. 6) Respondent also suggests that those two other Circuits might well reconsider their determination in light of the Ninth Circuit decision.

To take the second point first, it should be noted that the Second Circuit on December 20, 1974, three months after the Ninth Circuit decision, albeit without reference to it, reaffirmed its adherence to the *Stella* case in *Perine* v. *William Norton & Company, Inc.,* CCH Fed. Sec. L. Rep. ¶94,922 (Current Volume). The court there said: "Applying the plain language of the rule as thus interpreted [referring to *Stella*], Norton became an insider when it purchased more than 10% of Designcraft's stock." (*Id.* at 97,171) The Court of Appeals there additionally relied on the identical holding in *Newmark* v. *RKO General,*

Inc., 425 F. 2d 348 (2d Cir.), *cert. denied* 400 U.S. 854 (1970).*

As to Respondent's reference to "only" two Circuit Courts having reached contrary conclusions, *no* extant decision supports the Ninth Circuit's decision, the one District Court case to have reached the same result having been overruled, *sub silentio,* by the Eighth Circuit. (See Petition, p. 13) Moreover, in addition to the direct holdings of the Second and Eighth Circuits, both the Sixth and the Seventh Circuits have reached the same result by implication or alternative holding with respect to persons who were both 10% shareholders and officers or directors: *Bershad* v. *McDonough,* 428 F. 2d 693 (7th Cir. 1970), *cert. denied* 400 U.S. 992 (1971); *Champion Home Builders Co.* v. *Jeffress,* 490 F. 2d 611 (6th Cir. 1974), *cert. denied,* 42 U.S.L.W. 3631 (May 14, 1974). At present, this question is again before the Seventh Circuit: *Allis-Chalmers Manufacturing Company* v. *Gulf & Western Industries, Inc.,* Docket Nos. 74-1266 and 74-1267, the issue having been decided in conformity with *Stella* by the court below, 372 F. Supp. 570 (N.D. Ill. 1974). See also *Kahansky* v. *Emerson Radio & Phonograph Corp.,* 184 F. Supp. 90 (S.D.N.Y. 1960); *cf. Booth* v. *Varian Associates,* 334 F.2d 1 (1st Cir. 1964), *cert. denied* 379 U.S. 961 (1965).

Moreover, numerous cases on both the Circuit and District level have held the initial purchases by officers and directors subject to Section 16(b), even when such purchase

* Respondent refers to the *Newmark* discussion on this point as "dictum" (Res. Br., p. 6, n. 6), but on the contrary, such a finding was necessary to the court's determination of liability on the insider.

was made *before* the individual became an officer and director: *Adler* v. *Klawans,* 267 F. 2d 840 (2d Cir. 1959);* *Blau* v. *Allen,* 163 F. Supp. 702 (S.D.N.Y. 1958); *Blau* v. *Hodgkinson,* 100 F. Supp. 361 (S.D.N.Y. 1951); *Booth* v. *Varian Associates, supra* (point assumed without discussion). A "not-yet" director can hardly be said to have more access to inside information than a "not-yet" shareholder who is engaged in intensive negotiations preparatory to acquiring a major position in the issuer's equity.

In a number of other situations where the potential for speculative abuse existed (and sometimes when it existed only at the time the profit was realized from the second transaction) the courts have been quick to find that the initial transaction was within the statute's ambit, even though a literal reading of the statute might not have supported the conclusion. For example, prior to 1964 when the statute applied only to transactions in securities of "listed corporations," a federal court held that the purchase of an equity security prior to its listing on a national securities exchange, when matched with the sale of a security of the same class following such listing and within six months of the purchase, created a liability for insider's profits. *Perfect Photo Inc.* v. *Grabb,* 205 F. Supp. 569 (E.D. Pa. 1962). Similarly, *Feder* v. *Martin Marietta Corporation,* 406 F. 2d 260 (2d Cir. 1969), *cert. denied* 396 U.S. 1036 (1970), held that a purchase of an equity security by a

* Indeed, *Adler* v. *Klawans, supra,* in reaching the above-described result, referred to and relied upon the *Stella* decision, while acknowledging that it was not directly applicable, to illustrate "that the purpose of the statute is remedial, rather than penal, and that it must be strictly construed in favor of the corporation and against any person who makes profit dealing in the corporation stock." 267 F. 2d at 846-47.

company having a representative on the issuer's Board of Directors could be matched with a sale of such security, within six months, even though the representative had ceased to be a director of the issuer at the time of the sale. SEC Securities Exchange Act Release No. 8574 (April 17, 1969), issued shortly after and based upon the principles propounded in the *Feder* decision, observed that Section 16(b) would seem to apply "where equity securities become registered, or cease to be registered, between the dates of purchases and sales, or sales and purchases, made within a period of six months." All of these decisions reflect a recognition of the dominant statutory purpose of providing a highly efficient and virtually automatic remedy against the possibility of abuse of inside information by speculative short-swing trades in equity securities by insiders.

II

The basic thrust of Respondent's Brief in Opposition is an attempt to bring this case within the umbrella of *Kern County Land Co.* v. *Occidental Petroleum Corp.,* 411 U.S. 582 (1973). Respondent points out that prior to its entry into the Purchase Agreement with Foremost, it owned no Foremost securities and, repetitiously quoting from *Kern,* urges that §16(b) is not aimed at speculation which "could not have been based on inside information obtained from substantial stockholdings that did not yet exist." *Id.* at 597. (Res. Br. pp. 3, 12, 14). This argument betrays a desperate striving to inject into the case a defense predicated on Respondent's alleged non-possession of inside information.

The statute itself offers as its purpose the prevention of unfair use of information "which *may* have been obtained by such beneficial owner". (Emphasis added.) This stated purpose is, of course, consistent with the history of the legislation and with all judicial and administrative precedents.

If all of this had not made it clear that the statutory purpose requires that the courts be excused from grappling with subjective intent, surely the Ninth Circuit's opinion should have put this underlying issue to rest, at least for this case. Not only did the Court below determine that the transactions in issue were to be measured by objective standards without reference to intent or potential for abuse, but it articulated a fall-back position—even if a pragmatic inquiry were appropriate, it said, Respondent's actions may have reflected "exactly the kind of speculative abuse that section 16(b) is designed to discourage" (8a), because "[T]he general cooperation involved in the transaction would indicate that Provident conferred intimately with the Foremost management and could well have had access to confidential corporate information" (7a).*

It is contended that, despite this "cooperation", Provident, prior to its purchase of the Debentures, could not

* The statement is substantiated by the record. Provident had in 1968 employed Dillon, Read & Co. ("Dillon Read") to analyze its financial structure and prospects. (R. 251) As a result of its recommendations, Dillon Read was then employed by Provident to search for suitable purchasers and "to negotiate and analyze . . . any offers which may result . . . ." (Docket Entry #35, Ex. 1, p. 18) It was on the basis of the analysis of Foremost's offer undertaken by Dillon Read and on its recommendation that Provident entered into the transaction. (See Docket Entry #17, Ex. D) Unlike the *Kern County* situation, neither the purchase nor sale of the Foremost Debentures by Provident was anything but voluntary.

have acquired inside information "by reason of [its] relationship to the issuer." A similar contention was discussed by the Securities and Exchange Commission more than two decades ago. In its *amicus* brief in *Stella* v. *Graham-Paige Motors Corp.*, it said:

> "A person who acquires a large block of stock in a single transaction normally has access to inside information. He necessarily would deal in the negotiations looking toward the purchase, with either the issuer or an insider holding a large interest in the issuer. In either event he would be in a position to bargain for disclosures not available to the public. It is against abuse of information so obtained as well as of information obtained after representation in management is secured that the section is directed." Brief for the SEC as *Amicus Curiae*, pp. 5-6, *Stella* v. *Graham-Paige Motors Corp.*, 104 F.Supp 957 (S.D.N.Y. 1952).

More recently, one of the anonymous commentators relied upon by Respondent seems to have reached the same conclusion. See, Note, *Insider Liability for Short-Swing Profits*, 72 MICH. L. REV. 592, at 616, nn. 90, 91 (1974).

Other considerations as well lead to the conclusion that this Court's reference in *Kern County* to lack of inside information "from substantial stock holdings that had not yet existed" was offered only in the context of a hostile tender offer—a situation which is the very antithesis of a cooperative negotiation involving the exchange of information prior to the time of purchase.* Thus, for example,

* In a recent decision, the Second Circuit commented as to *Kern County*: "We believe that *Kern County* holds the defensive merger situation to be *sui generis* in terms of §16(b) liability." *American Standard, Inc.* v. *Crane Co.*, CCH Fed. Sec. L. Rep. ¶94,924 at 97,186 (2d Cir., 1974).

Section 3(a)(11) of the Act (15 U.S.C. §78c(a)(11)) defines an "equity security" to include any "stock or similar security" or "any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security . . . ." If the draftsmen of the statute had in fact intended to exclude, *as a class,* transactions which "could not have been based on inside information obtained from substantial stockholdings that did not yet exist," they would not have defined "equity security" so as to include a warrant or a right or a convertible debenture. It cannot seriously be argued that one who has invested a comparatively small sum to purchase warrants or rights (which perhaps years later, and only after making a much larger payment, can be exchanged for 10% of an issuer's common stock) has a greater opportunity "by reason of his relationship to the issuer" to obtain inside information than does a responsible person who is negotiating in earnest through investment bankers to buy upwards of 10% (or for that matter 75% or more) of the equity of a major publicly-held company.

Indeed, in this case, it was Respondent's purchase of convertible debentures that lead the Ninth Circuit to conclude that "Provident became a beneficial owner of more than 10 percent of a class of Foremost equity securities." (3a) When the purchase of convertible debentures gives one the right to acquire more than 10% of a class of equity securities, such purchase falls within the statute's reach. *Chemical Fund, Inc.* v. *Xerox Corporation,* 377 F. 2d 107 (2d Cir. 1967). This result is of course consistent with the definition of "purchase" in Section 3(a)(13) (15 U.S.C.

§78c(a)(13)) which includes as a purchase a mere right to acquire equity securities pursuant to a contract. In neither the case of warrants or convertible debentures nor in the case of a contract to buy does the statute permit it to be said that a relationship sufficient to permit the abuse of inside information does not exist. Yet in all of these cases "substantial stockholdings . . . did not yet exist." Obviously it is not the ripening of the equity ownership, but the potential for obtaining inside information in connection therewith, which may in turn result in cashing in a profit within six months by means of a matching transaction, with which the statute is concerned.

III

Respondent contends that the clause of Section 16(b) which exempts a transaction where the 10% beneficial owner "was not such both at the time of the purchase and sale", means that the initial purchase of 10% of the stock should not be matched with a sale within six months. While the legislative history may not afford a clear explanation of the proviso, we submit that this clause was designed primarily to ensure that 10% shareholders who had reduced their holdings to less than 10% would not be held liable for their subsequent sales: "[T]he intention of the language was to exclude the second sale in a case where 10% is purchased, 5% sold within three months and the remaining 5% a month later." E. Seligman, *Problems Under the Securities Exchange Act,* 21 VA. L. REV. 1, 20 (1934), quoted with approval in *Reliance Electric Co.* v. *Emerson Electric Co.,* 404 U.S. 418, 423, n. 3 (1972). In that case this Court

rejected an interpretation of the statute which would have imposed liability on "all sales within six months by one who has gained the position of a 10% owner through voluntary purchase, regardless of the amount of his holdings at the time of the sale" (*id.* at 426), but said nothing about exempting that initial purchase. The clause may also be read to ensure, in the context of a "purchase" transaction analogous to the "sale" transaction involved in *Emerson*, that one who purchases 6% of the corporation's stock and then another 6%, would not have the first purchase matched against a sale of 8% within six months.

To reiterate a point made in our petition, if there is ambiguity in the language of the proviso, there can be no doubt that the statute's expressed purpose of "preventing the unfair use of [inside] information" is best carried out by the interpretation which includes the initial purchase by a 10% holder with Section 16(b):

> ". . . There is no surer guide in the interpretation of a statute than its purpose when that is sufficiently disclosed; nor any surer mark of oversolicitude for the letter than to wince at carrying out that purpose because the words used do not formally quite match with it." *Federal Deposit Ins. Corp.* v. *Tremaine*, 133 F. 2d 827, 830 (2d Cir. 1943) (L. Hand, C.J.).

Conclusion

The Ninth Circuit's decision creates a clear conflict among the Circuits and a fundamental uncertainty in the administration of a statute with respect to which predictability was a principal legislative goal. The decision is in

conflict with the stated legislative purpose of preventing the unfair use of information which may have been obtained by a 10% owner of equity securities. We respectfully submit that for the foregoing reasons, the petition for certiorari should be granted.

Respectfully submitted,

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